MORTGAGE BULLETIN

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"LINCHPINS" OF A MORTGAGE PORTFOLIO

A celebrated English statesman has referred to the King and Queen as the "linchpins" of the British Empire. We like this old English word and the sturdy secureness it stands for, and we believe linchpins can be used appropriately as a symbol of security in building a mortgage portfolio.

It has become a major problem for savings institutions to invest their funds conservatively and produce earnings adequate for dividends and expenses, and, in addition, satisfactory increases to surplus. The solution depends primarily on the success of the lending institutions in acquiring a substantial volume of mortgage loans. Hence, a new loan production policy should include a form of protection for risk assets to keep future losses at a minimum.

We recognize that a mortgage policy must be flexible to meet the ever changing conditions in the broader market of real estate. It is this changing real estate market which makes top-notch appraisals so important. The difference between securities and the real estate mortgage type of investment is that the former are quoted daily on the Exchanges and have a known market value, while mortgages have intangible elements and unknown value, except as determined by appraisal. It has been said that price is an historical fact, while value is an opinion based on prospects in the future. Therefore, it is highly important for those entrusted with the investment of mortgage funds to employ a thoroughly qualified and experienced appraiser who can analyze real estate trends and reflect probable future value in his appraisals. A prudent lender is as much concerned with probable future sale price as with the one prevailing at the time the loan is made. It should be realized by lenders that the scale of modern appraising is dwarfing the "guesses" of the old style loan committee with its mistake of ignoring a scientific approach to present worth. The legal limitation on the amount of a loan in relation to appraised value has little force or significance without a competent appraisal. A foggy and uninformed appraisal has too often made a 66-2/3 per cent loan an 80 or 100 per cent headache. So any way you figure it, an accurate and realistic appraising job is a number one safeguard in building a mortgage portfolio.

The universal adoption of the amortized mortgage was a great forward step in home financing as it reduced the risk element and gave the mortgage account a fluidity and liveliness it never had before. But now at long last it has brought a serious problem for the lender. And that is the reduction by repayments of the principal amounts in the mortgage portfolio at a time when desirable replacements are becoming more and more difficult to implement. Contract principal repayments are running one to two per cent per month and with the inclusion of pay-offs, satisfactions and assignments, the annual reduction of the mortgage port-

folio has reached a per annum figure of 12 to 15 per cent in many institutions. This heavy attrition is resulting in a disproportionately large percentage of new, unseasoned mortgages being added to the portfolio. To illustrate: Here are the figures of a large Massachusetts savings bank for the first four months of 1948:

New mortgages accepted		$1,426,000
Mortgages paid off . . .	$414,576	
Amortization payments	320,040	734,616
Net gain		$ 691,384

We know that savings institutions must increase their mortgage portfolios, but we are convinced that it is unsound practice to invest too large a part of deposit assets in mortgages in any single year. The acquisition of mortgages should be interspaced so that when the impact of a declining real estate market knocks down values, most of the mortgages in the portfolio will have had a period of seasoning and the loan to value ratio will have been materially reduced by the contract principal payments. The record indicates that loans made near the end of a real estate boom have turned out to be the most troublesome. Real estate activity dropped from 42.4 points above the computed normal in January last to 22.4 at the end of October, and we believe this trend will continue except for minor recoveries. With no mincing of words, we are in a spot where lenders, hungry for mortgages, can become involved in loans which may cause headaches later. In our judgment, applications should be carefully screened and mortgage investments in any one year held within ten per cent of a bank's total assets. We suggest this limitation as a further safeguard to be vigilantly observed.

Generally speaking, mortgages fall into three classes, conventional, FHA and GI loans. More lenders favor the conventional type mortgage than the Federally insured loan. However, most large housing projects are developed with FHA financing. Institutional lenders who confine their mortgages to the conventional type loan seem firm in their conviction that they do not want the government dictating the pattern of their mortgages. Some of these bankers concede Federal insurance may serve a useful purpose in depression periods but contend it is definitely unnecessary and inflationary in boom times. Such lenders maintain they prefer to make their own appraisals and that they are in a better position than the FHA to determine whether an applicant for a loan is a satisfactory credit risk. Their position is that if the banks refuse to assume the risks involved in mortgage lending it will result in creating more Federal competition in home financing. But their real resistance to Federally insured mortgages is attributable to the profit motive. In other words, the spread in interest rates obtainable from conventional loans is more attractive and the higher earnings provide for any losses that may come later.

We heartily agree with the conventional lenders that the government program of easy housing credit has been, and is, a strong inflationary factor and we would like to see both FHA and the Veterans Administration tighten their lending policies and stop insuring loans which, by all normal standards, are unsafe.

Although there has been some change in the economic climate in recent weeks, the welcome mat for inflation is still before our door --- if I read the auguries correctly. Construction costs keep edging up and high prices for new houses exist country-wide. This continues the strained relationship between market value and

present worth for loan purposes. Of course, this worsens the situation for the conventional lender as the risk factor is intensified. While many bankers infer they can take care of their foreclosure losses for less than the FHA insurance of 1/2 of one per cent, some of the records challenge this assurance. In a recent study made by Dr. John Lintner of the Harvard Business School for the Mutual Savings Banks of Massachusetts, the figures show that in the twenty-year period from 1926 to 1945, losses on mortgages represented a little less than 0.9 per cent a year; in the period from 1907 to 1945 losses on mortgages amounted to 0.61 per cent a year, and if the years from 1931 to 1945 are used the loss was 1.2 per cent. During the past few years of inflation, foreclosures have been scraping the bottom of the barrel but this experience is not a suitable yardstick for measuring future expectancies.

We believe it is quite generally admitted that FHA mortgages are an excellent investment --- on the whole they may be regarded as riskless assets --- for a savings institution. It is also an established fact that over the nation many institutions have had a very satisfactory experience with their FHA portfolios. They gladly give FHA credit for top-grade administration and for instituting high standards in lending practice. It is true that these loans have an unrestricted prepayment option but they are more liquid than conventional mortgages in event of difficulties, and the insurance feature limits the losses if trouble comes to pass. In present-day parlance FHA mortgages are "naturals" for institutional investment and there should be a place for them in every portfolio.

The construction dollar is buying only 46.2 per cent of what it bought in 1939 and the cost of building our "guinea pig" house has increased 148 per cent above the same bench mark. There is no depth to the current market as the high prices of houses are prohibitive for all but a relatively small percentage of American families, and when this market is depleted either construction costs must come down substantially or private residential building may practically come to a stop. New housing starts for September and October slumped from the figures of the same months of 1947; the drop was 34,000. Real estate sales have also slackened. We believe the present boom will deviate little, if any, from the pattern of the real estate cycle. The next readjustment period may bring a very considerable change in the selling price of existing buildings, even more than some lenders expect. The older the buildings the greater will be the price drop. With such a probability in prospect it is suggested that approximately fifty per cent of mortgage investments in insured loans would be a safeguard that no portfolio should be without.

The fourth "linchpin," or safeguard, is a mortgage reserve account for uninsured loans. The ordinary surplus account should be a primary reserve to be used only when, and if, the mortgage reserve account has been exhausted. The mortgage reserve is for the protection against losses inherent in mortgage lending that cannot be clearly recognized but which experience has taught will in all probability reoccur sometime in the future. During the trouble years in the past when interest rates were higher, banks reduced dividends to take care of heavy foreclosure bruises, but this would be impracticable in these times. Some State banking departments have indicated that perhaps 1/2 of 1 per cent each year of the principal amount of all uninsured mortgages is sufficient to allocate to a mortgage reserve account, but we are of the opinion that one per cent (two per cent if possible) should be set aside until the mortgage reserve reaches an amount which the

bank estimates as adequate. After that perhaps 1/2 of one per cent may be sufficient. For banks which have not already set up a mortgage reserve account there could be no more propitious time than the present for starting such a cushion.

Sour notes in the mortgage business:

Insistence by Washington on a maximum interest rate of four per cent for loans made under Title VI, Section 608.

The $6,000 loan limit per house on large groups (25 or more) of small houses built by on-site builders under Title VI, Section 611.

The reluctance of the Veterans Administration to raise the interest rate on GI loans to 4-1/2 per cent as authorized by Congress.

Limiting purchase by the Federal National Mortgage Association (Fanny May) to fifty per cent of GI and FHA mortgages made subsequent to April 30, 1948.

Warning by Senator Joseph R. McCarthy of Wisconsin, who was vice-chairman of the Congressional Committee on Housing, of the possibility of direct government competition if lending agencies failed to liberalize their home financing policies on low-priced houses.

However, a sweet note for all business came out of Washington on November 23, when Dr. Edwin G. Nourse, chairman of the Council of Economic Advisers, announced that the President had instructed him, and an assisting team of Cabinet members, to work out an anti-inflation program to be submitted to the Eighty-first Congress. If the President carries out his advocated policies of repealing the Taft-Hartley Act, increasing minimum wages and unemployment insurance, and implementing his large subsidized housing program, Dr. Nourse and his associates may have to use some economic alchemy to prevent another round of inflation.

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